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GREECE: Austerity After a Year

SUMMARY

The setback suffered by Prime Minister Papandreou's Panhellenic Socialist Movement in the 19 October municipal elections most likely means that Papandreou will not supplement the austerity measures he introduced a year ago with more meaningful structural reforms. He will not, however, abandon the measures announced last November. The net result will probably be that Greece will be able to continue staving off a financial crisis thanks to EC loans but unable to make significant progress in overcoming its economic difficulties. Thanks to his commanding majority in Parliament, however, Papandreou himself is almost certain to stay in power until regularly scheduled elections in 1989.

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Faced with the embarrassing possibility of being forced to seek IMF assistance, Papandreou announced a number of austerity measures last fall. These included a 15 percent devaluation of the drachma, substantial advance deposits on imports, reduction of the wage-indexation formula, and higher taxes coupled with tougher penalties for evasion.

The shock of austerity caused the economy to contract in 1986; GDP will fall about 0.5 to 1 percent this year compared to growth of 2.1 percent in 1985 primarily because of slumps in the service sector and agriculture. Unemployment, currently at 8.5 percent, may climb to 9 percent by the end of the year.

Papandreou can point to a significant improvement in the current account deficit, but this amelioration was wholly due to factors outside the scope of the austerity program. The current account deficit for January-August decreased 39.7 percent to $1.2 billion against a deficit of $2 billion in the same period of last year, but the drop in oil prices saved Greece $726 million, and higher net EC inflows and tourist receipts provided $359 million and $244 million respectively. In fact, non-oil imports for January-August have risen 14.8 percent compared to last year. Exports, in contrast, have only increased 1.5 percent over the same period.

Inflation has largely offset any benefit in Greece's non-oil trade position from the devaluation. We estimate that the drachma has recovered at least two-thirds of last November's 15 percent devaluation on a price-adjusted exchange rate basis. Demand for imported goods remained strong despite the devaluation and a 5- to 7-percent drop in real wages caused by the reduction in the wage indexation formula. Greek consumers apparently depleted savings or spent extra income earned in the underground economy.

Greece has already admitted that it probably cannot reduce inflation to 16 percent by the end of the year, as targetted. Prices rose 24 percent in the year ending in August 1986, the same as last year, spurred by excessive money supply growth. Rapid increases in the money supply and bank credit caused Athens to attempt to restrain consumer borrowing which led to a "credit squeeze" in the private sector this summer. Greece's persistent capital flight problems, prompted primarily by inflation, also aggravated the credit situation.

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The public sector borrowing requirement (PSBR) which reached 18 percent of GDP last year, may decline slightly. Athens has been unwilling to cut credit to the public sector, which absorbs about two-thirds of available credit, because public enterprises and entities regularly face severe cash shortages. The chronic operating deficits of the Urban Transport Organization, the Greek State Railways, the Hellenic Aerospace Industry, the Public Power Corporation, Olympic Airlines, and the telephone and postal services, plus two government social insurance funds, accounted for $1.67 billion or 27 percent of the PSBR, and another 15 percent is due to agricultural subsidies. Part of the PSBR is financed by the Bank of Greece, thereby increasing the money supply and aggravating inflation. An increasing portion of the remainder is financed through foreign borrowing (41 percent in 1985), which must ultimately be repaid through export earnings.

Papandreou hoped to lower the PSBR to 14 points of GDP solely through revenue increases, principally stricter tax enforcement. The government expected to generate $654 million by cracking down on tax evasion, but is unlikely to raise this much in a year of falling household income. Indeed, Athens was forced to raise the prices charged by public enterprises by 15 percent in August, a move which will boost revenues by about $200 million-- and inflation by one percentage point--to allow the enterprises to pay their current bills.

The cash flow problems of the public enterprises stem from their inability to collect some $250 million in unpaid and probably uncollectable bills from the 43 "ailing" enterprises now under government management, and from other firms in dire financial shape. These firms have suffered from government imposed labor market rigidities and price controls. These problems, plus Papandreou's manifest anti-business philosophy, have also discouraged long-term foreign investment in Greece.

In September, Papandreou announced his intention to implement some structural reforms, stating that wages must be linked to productivity and that unprofitable firms would no longer be subsidized. The government had already announced that it would liquidate 20 firms that were nationalized under the "ailing enterprises" law, and that it would privatize the remaining 23 unless they were deemed

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strategically important. Some Greek businessmen also expected the government to ease rules for the dismissal of workers.

None of these reforms is now likely. The public has registered its dislike of Papandreou's belt-tightening measures by voting PASOK mayors out of office in the three largest cities-- Athens, Piraeus, and Thessaloniki-- during country-wide municipal elections on 12 and 19 October. The election results are likely to restrain Papandreou from pressing forward with the planned structural changes, especially since they could boost the unemployment rate from its current 8.5 percent to about 10 percent.

Instead, Papandreou appears to have chosen to treat symptoms again by freezing the prices of all goods and services, domestic and imported, until the end of January. The freeze was probably instituted at least in part to ease worker discontent over falling real incomes. It may well, however, lead to shortages, a worsened current account situation, decreased investment, and greater unemployment because of business failure.

Greece's best hope for relief lies with the EC. Last November, Greece became the fourth Community member to turn to the EC for a balance-of-payments loan. Athens obtained a $1.5 billion loan commitment after agreeing to reduce the balance-of-payments deficit, lower the PSBR to 14 percent of GDP, and get inflation down to 16 percent by 1987. The second tranche of the loan, about half, will be released in January if the EC Commision approves of Greece's progress in meeting these terms. Papandreou almost certainly believes that the price freeze will improve his bargaining position on release of the second tranche.

Although Greece has little chance of satisfying all the conditions set by the EC for disbursing the remainder of the loan, the EC is likely to go ahead with the loan after getting Papandreou's commitment to tighten economic policy in 1987. If so, Papandreou will not be forced to seek IMF assistance. Without basic changes such as liberalization of the state-dominated economy and a stricter monetary policy, however, the Greek economy will continue to deteriorate slowly. Nevertheless, Papandreou still enjoys a strong majority in parliament and will probably have no difficulty maintaining his government in power until the national elections in 1989.

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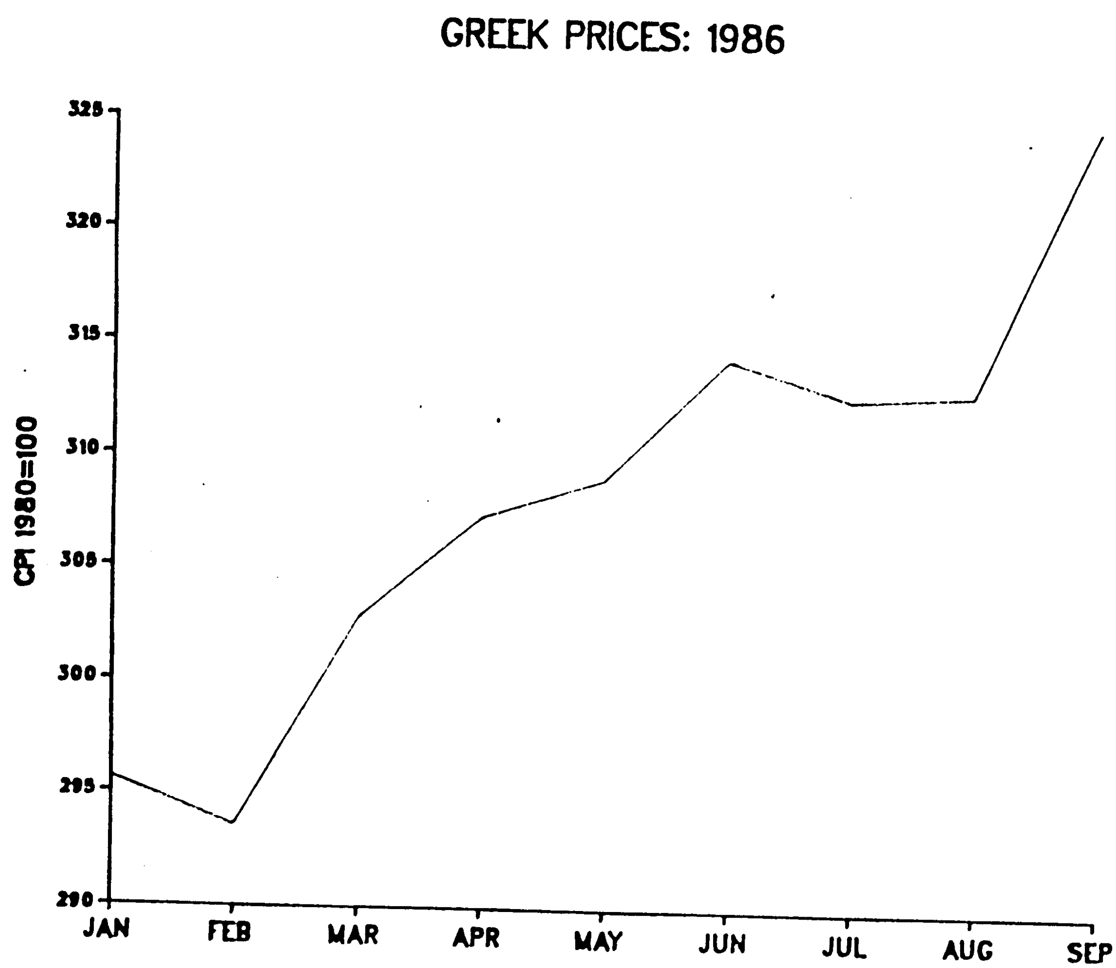

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Greek Current Account: 1986

	(Aug'86)	LATEST PERIOD (Jan-Aug 86)	PERCENTAGE CHANGE FROM PREVIOUS YEAR (Month)	(Period)
IMPORTS (CIF)	703	6,562	7.7	-3.6
(1) FUEL	86	1,152	-64.9	-45.0
(2) OTHER	617	5,410	51.2	14.8
EXPORTS (FOB)	342	2,847	-3.7	1.5
(1) FUEL	33	354	-28.3	-37.8
(2) OTHER	309	2,493	-	11.6
TRADE BALANCE	-361	-3,715	-21.1	-7.1
INVISIBLE RECEIPTS	362	4,140	3.9	22.6
INVISIBLE PAYMENTS	180	1,632	5.9	18.4
BALANCE OF INVISIBLES	452	2,508	3.2	25.4
CURRENT ACCOUNT BALANCE	91	-1,207	-35.0	-39.7

In Millions of Dollars

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